

APPENDIX

Notes for FOMC Meeting

May 20, 1980

Scott E. Pardee

Since the last meeting of the FOMC the dollar has declined a net of 3 percent against the German mark, 2-3 percent against other European currencies, and 8 percent against the Japanese yen. Most of this decline was in the first week after the FOMC meeting, when interest rates were coming off sharply in the United States and when the Iranian situation was in the market's focus. Since then, and even though U.S. interest rates tailed off further, the dollar has held its own. Intervention has been relatively light.

Most of us I guess would regard this more recent stability as a rather [remarkable] performance for the dollar. Most seasoned dealers with whom we have talked lately would agree. [Unintelligible] between the [unintelligible] interest rates and evidence of improvement in our trade account and inflation performance. By late April market participants began to respond to the growing signs that the U. S. economy has moved into recession and that the recession might be deeper than previously anticipated. Signs of a slowdown reinforced expectations that our trade and current account positions would improve and the trade figures for March--released in late April--did show a clear narrowing from the previous figures. In addition, expectations began to grow that our price performance would improve, again because of the domestic slowdown. Following earlier glimmers in individual price series released in late April, the market waited with bated breath, and with few long dollar positions, for the producer price index for April to be released on May 9. The result, 0.5 percent, or a 6 percent annual rate, was a welcome relief. And although it did not set off a dollar rally, at least the possibility that the U.S. inflation rate might be easing over the next months took some of the bearishness out of the dollar market.

Meanwhile, this somewhat improved sentiment toward the dollar from our side of the Atlantic helped the dollar weather any after-effects of the Bundesbank's action on April 30 to raise yet one more time its discount and Lombard rates. This action on official rates followed the previous rise in market rates in Germany and was accompanied by [steps] to release liquidity, with the result that market rates did not advance further there. [Unintelligible] around 10 percent. Only the Dutch followed, but other central banks that had been hoping to be able to ease up a bit had to stay firm.

In explaining why the mark did not rise by more against the dollar, market participants cite Germany's own problems--a sizable current account deficit expected for this year, election uncertainties in Germany, and Germany's vulnerability to any exacerbation of East-West pressures. [Unintelligible.]

[Contributing] to the relative stability of the dollar, at least against the mark and other continental European currencies, was the relatively close coordination of

intervention we have been able to achieve with the Germans over the recent weeks. Both central banks have much to lose in terms of their domestic policy objectives if the exchange market suddenly becomes unsettled. So we have both been quick to step in to counter sudden bouts of selling pressure on the dollar. Market participants have sensed this, with the result that we have had to intervene less than at other times when the dollar was under a cloud.

Mr. Chairman, I have done my best to provide perhaps the only bit of cheer the Committee may have at this meeting, but I would be remiss in not pointing out that market participants are seriously concerned that the interest differential between the United States and Germany, however measured among comparable short-term instruments, has virtually disappeared. [Bundesbank officials] stress that in view of inflation in their country they do not intend to ease [unintelligible] interest rates over the near term even though a substantial differential prevails in terms of relative rates of inflation. Foreign exchange traders and financial people generally believe that as long as the current interest rate constellation holds, it is only a matter of time before a major flow of funds develops out of dollars and into marks, particularly by OPEC diversifiers who are currently so flush with funds.

To summarize our actions, the Desk sold a total of \$377 million equivalent of marks for the U.S. authorities, of which \$228 was for the System. Net of repayments, our swap drawings on the Bundesbank now amount to \$331 million equivalent. The Desk also sold \$25 million equivalent of Swiss francs from balances. Finally, our swap debt in French francs remains at \$74 million, with no further operations during the period.

Reporting on open market operations, Mr. Sternlight made the following statement:

In seeking to meet the reserve growth objectives associated with the Committee's desired monetary growth since the last meeting, the Desk encountered progressively slower monetary growth and weaker demand for reserves. Since we supplied nonborrowed reserves about in line with path, borrowings fell off sharply and money market conditions softened dramatically. The average Federal funds rate in the week of April 23, which included the last regular FOMC meeting, was about 17 1/2 percent--already a decline from the peak of 19 3/8 percent a few weeks earlier. In the week ended last Wednesday, the rate averaged 10 7/8 percent--down about 45 percent from the peak average week. Other rates also fell across a broad front. In the current week, the funds rate has averaged a little higher so far--about 11 1/4 percent, even though we have sought to provide sufficient non-borrowed reserves this week so that there should be virtually no need for adjustment borrowings at the discount window. By comparison, a \$1.5 billion level of adjustment borrowing had been assumed in constructing the nonborrowed reserve path for the early part of the period. In the course of the interval, as you know, the Committee reduced the lower bound of the Federal funds rate to 10 1/2 percent, as the steep drop in market rates appeared to make it infeasible to meet nonborrowed reserve objectives and also stay within the earlier 13 percent lower bound.

Reflecting the unusual decline in money supply, it looks at this point as though total reserves will average close to \$850 million below their path average. Nonborrowed reserves, on the other hand, appear to be coming out about on path.

In conducting operations over the period, we had a continuing concern that the seemingly generous provision of reserves and decline in market rates might be misread in the markets as denoting a lessened determination to deal with inflation, but I do not believe that our job of reserve provision was essentially impeded by this concern. On a few occasions, a desire to avoid over-stimulating the market affected somewhat the timing and manner chosen to provide reserves.

Outright operations during the period included purchases of about \$900 million of Treasury coupon issues and net purchases of nearly \$300 million of bills from foreign accounts. The System arranged its own repurchase agreements on only one occasion during the interval, but some of the foreign account repurchase transactions were passed through to the market several times toward the end of the period. Matched sales transactions were employed at times to absorb reserves from the market and were arranged daily with foreign accounts as well.

The most pronounced yield declines in the recent period were for shorter maturities. Treasury bill rates pushed down to about 8 percent last week before backing up to around 9 percent in the last few days. This compares with key bill rates in the 11 to 13 percent area at the time of the April Committee meeting and 14 to 16 percent a few weeks earlier. In yesterday's auctions,

3- and 6-month bills went at average rates of 8.92 and 8.95 percent, compared with 12.73 and 11.89 percent four weeks earlier.

For intermediate term coupon issues maturing in about 1 to 4 years, yield declines in the recent period were largely in a range of 1 to 2 1/2 percentage points, while longer issues were mostly down about 1/8 to 1/2 percent in yield. Coupon issues had already undergone a substantial drop in rates from late March to late April. The further decline through about half of the most recent period continued to reflect reports of weakness in the economy, a view that inflation might tend to abate somewhat, declines in money and credit aggregates, and a sense that the Federal Reserve was at least tolerating if not promulgating a distinct easing in money market rates.

In the final week or so of the period, rates have backed up, reversing a portion of the earlier declines. This seems to have stemmed from several factors, including higher dealer financing costs, a feeling that monetary growth might be resuming, and that earlier declines had been overdone at least for the time being. In the Treasury coupon sector, dealers managed to stock up on the new Treasury refunding issues when rates were at about their recent low point, and now the market has incurred some losses as prices have come down in the course of seeking to distribute the large takedowns, especially of the longer maturities.

Market views seem to be mixed as to where rates go from here. Some see the very recent rate rise as a temporary setback, likely to be followed by renewed, if less spectacular declines,

in coming months--essentially because of deepening recession. Others feel that rates may fluctuate close to current levels, as forces such as weakness in the economy, continuing inflation, and mixed credit demands from different sectors about offset one another. Indicative of dealer views, their positions in over-1-year maturities, which were around \$1 billion a month ago, climbed above \$3 billion as they took on supply in the refunding auctions. Subsequently, the over-1-year inventory has worked down closer to about \$2 billion, but this is probably still higher than the dealers in the aggregate would prefer.

Treasury financing demands should not be too great for the next month or so, as we come up to a period of seasonal surplus. There may have to be a cash management bill in early June, though, to get past a cash low point before the June tax receipts pour in. Also, there could be some difficulties in just the next few days as we face another cliff-hanger on the debt limit which drops precipitously at the end of May. Conceivably, the Treasury would want to accelerate a cash management bill to get payment before month-end.

James L. Kichline
May 20, 1980

FOMC Briefing

Information on economic developments early in this quarter suggests activity is contracting substantially. The staff has revised downward its forecast of real GNP for the second quarter, and now anticipates a decline of around 6 percent at an annual rate. The available evidence indicates that weakness in the economy during recent months has become widespread, extending well beyond the auto and housing sectors.

The nominal value of total retail sales dropped further in April, the third consecutive monthly decline. Excluding autos, gasoline, and nonconsumption items, the fall in sales since January has been the weakest three-month performance in the 13 year history of the series. Auto sales, too, have been weak and in April the annual sales pace of 8-1/4 million cars was nearly one-fourth below the first-quarter pace; sales of both foreign and domestic units, including large and small-sized models, declined. Available reports suggest tighter credit conditions following the March 14 policy actions have played some role in damping sales of durable goods, particularly autos. It is not possible to pinpoint how much of the most recent deterioration in sales can be traced to the credit restraint program or how long those impacts might last. But it does seem clear that the decline in real disposable income has been at work in depressing consumer outlays and this force is unlikely to turn around quickly.

Personal income in April showed virtually no change in nominal terms, reflecting principally the adverse impact of labor market developments on wages and salaries. The average length of the workweek was shortened again in April and nonfarm employment fell by 1/2 million. The unemployment rate rose 3/4 percentage point to 7 percent and could show another sharp jump in May judging from the

continued appreciable rise in the weekly unemployment insurance claims figures since the April labor market surveys were taken.

The reduction in hours worked in April was associated with a substantial decline in industrial output. The industrial production index fell about 2 percent, the third consecutive monthly decline. Moreover, for the past few months, and especially in April, output declines have come increasingly to reflect weakness outside the sectors of motor vehicles and construction supplies. Given this weak performance of output, capacity utilization has continued downward and in April is estimated at 81 percent in manufacturing, nearly 6 percentage points below the recent peak utilization rates in the first quarter of 1979.

The growth of unutilized capacity and weak sales should tend to depress business investment outlays in the months ahead. New orders, capital appropriations, and capital spending surveys have yet to pick up any sizable deterioration in planned spending. But there are other signs pointing to a downturn in business spending. Order backlogs for machinery have been moving lower, nonresidential construction activity has slowed, business purchases of autos and trucks have declined, and announced cutbacks in business capital investment plans have risen considerably during the past two months or so. The staff forecast contains a decline of fixed investment spending beginning this quarter and continuing through the projection period.

In the housing market, in contrast, we expect housing starts to reach bottom in the current quarter and construction expenditures in real terms to begin rising later this year. Housing starts in April fell a little further to about 1 million units at an annual rate, while permits dropped 14 percent. But the recent easing of mortgage rates, and the reopening of commitment windows at some institutions, should help provide a foundation for an improvement in real estate markets in coming months. The expected upturn in housing starts, however, is

likely to be limited by the level of mortgage rates--which this year may not move below the 12 to 13 percent range for primary conventional mortgages--and by concerns about job and income prospects.

The staff's forecast of GNP still shows declining activity into early next year followed by a sluggish recovery. That outlook is also accompanied by a substantial rise of unemployment this year and a further drifting up of the unemployment rate to the 9 percent area in the latter part of next year. On the price side, we expect inflation to slow appreciably in the second half of this year and next in response to weak product and labor markets and the absence of another surge in oil prices. If judicial or Congressional developments preclude the imposition of the administration's oil import levy, that would reduce the projected rate of inflation by about 1/2 percentage point this year as well as add a little to real activity.

In concluding, I might note that it is difficult to judge the likely duration and depth of an economic contraction. Most recessions in retrospect tend to have their own special characteristics. In the current environment one could argue that we will experience a sharp decline in activity that will be short-lived and not severe measured from peak to trough. Arguments supporting this view could include, for example, a belief that consumers were shocked by the March 14 actions and will soon return to their freer spending ways, that inventories have been kept under good control, that businesses have pressing capital expenditure plans and will generally try to hold to them, and that the drop in interest rates will be very supportive of a recovery in housing and consumer spending. But it appears to us unlikely that a combination of such developments will be sufficient to outweigh the forces acting to depress activity, including the impact of inflation and restraining macroeconomic policies. Time, of course, will tell what will develop, but

the assumptions underlying the forecast and the condition of various sectors of the economy at the start of the downturn, have led us to hold to the forecast of a fairly severe recession and one that is dominated by a drop of final sales.

FOMC Briefing
S. H. Axilrod
May 20, 1980

As explained in the blue book, the very large shortfall of money growth in April makes it highly improbable that the targets for the aggregates set by the Committee for the December-to June period can, at this late date, be attained. The staff does project a rebound in money growth at around current interest rate levels--perhaps at about a 7 percent annual rate of growth for M-1A over May and June (with most of the growth in June). Even so, for the first half of the year M-1A would expand at only about a 1½ percent annual rate--which would be a little more than 3 percentage points below the Committee's objective for the period and well under the 3½ to 6 percent longer-run range for this aggregate.

I should stress that expectations for faster money growth in the May-June period are predicated in large part on the projection that nominal GNP will rise in the second quarter at a 4½ percent annual rate. If real GNP turns out to be even weaker than projected, leading to further weakness in nominal GNP, it is likely that the quantity of money demanded will continue to fall short of expectations and that the projected May-June money growth will not be attained except if accompanied by a sizable further drop in short rates, and possibly not even then. In that regard, the apparent continued decline in bank credit in early May--with outstanding business and consumer loans by large banks showing large further drops--suggests the possibility of continued deposit destruction at current interest rates and seems to lower the odds a bit on a sustained rebound of money growth over the very near term.

Given the recent weakness in monetary aggregates, the alternatives presented in the blue book focus on encouraging a rebound in growth. They

aim at relatively sizable growth rates in narrow money that get back to the middle of the longer-run ranges by either September or December. Such growth rates may appear tolerable, or even desirable, over the next month or two in view of the recent shortfall. Whether they should be sustained throughout the second half of the year of course need not be decided by the Committee today. That will depend in part on the Committee's attitude toward its longer-term ranges, or about where in these ranges it is willing to tolerate actual growth on the aggregates, and longer-run ranges will be formally reconsidered at the July meeting.

But in setting short-term aggregate targets today for money growth, it also seems relevant to point out that in recent weeks we have had some signs of a bit more strength, relatively speaking, in broader aggregates. Since the beginning of the year, M-2 and M-3 have been running low relative to the Committee's annual target ranges, but not as low as M-1. And since the beginning of May, a very substantial resurgence in money market fund growth has emerged, following the cessation of expansion in March and April in the immediate aftermath of the Board's March 14 regulations. Some of the very recent strength may be temporary, but we do not expect growth over the near term to evaporate again. I should also mention, while discussing broader money measures, that we now have our first indication for the behavior of L in March, one month when money measures began weakening perceptibly. In that month L remained relatively strong and expanded at a 9 percent annual rate--compared with an average growth rate of 10 percent in the previous 2 months--as the public's acquisitions of short-term U.S. government securities increased sharply.

In view of the small signs of life in the broader aggregates, while M-1 has been collapsing, it may not be unreasonable to ask whether the weakness of narrow money at least in part reflects efforts by the public to

economize on cash at a faster rate than had been allowed for in setting the narrow money supply target. M-1 growth in the second quarter is running very much less than would be predicted by our econometric models, given GNP and interest rates. But for really convincing evidence of a downward shift in M-1 demand, one would be more comfortable with persistent, large shortfalls of M-1 growth relative to model predictions--or with even a one-time shortfall if it were in combination with substantial growth observed in closely related assets or new innovations in financial technology. Nonetheless, the possibility of such a shift--perhaps in delayed response to the unusual interest rate peaks of late March--might argue for a cautionary approach in attempting to bring M-1 back to the midpoint of the longer-run ranges.

However, if such a shift is not taking place, it should be recognized that there are good odds that M-1 growth will rebound very rapidly sometime in the months ahead as the public seeks to rebuild excessively depleted cash balances. Permitting that to occur would not of course be inflationary under the circumstances, though there is the danger that any very sizable rebound might be so construed by domestic and international market participants.

Given the uncertain state of our evidence about money demand relative to income, and also uncertainty about the resiliency of the economy, it may be just as well that the Committee today does not really need to resolve the very difficult question of what rate of monetary growth it might wish to encourage in the second half of the year. However, it may wish to consider the desirability of aiming at this time to bring M-1 back into its longer-run growth range, without prejudice as to whether the upper, middle, or lower parts of the range represents the best long-run outcome. Either alternative A or B before the Committee will start that process.

While differences between A and B are not large in the very short run, they can be associated with substantive differences in perception about the economy and policy. If you take the view that the economy is very weak and that a significant longer-run downward shift in the demand for narrow money is not in process, alternative B may be the more appealing alternative. On the other hand, if there is a sense that such a money demand shift may be in process or that in any event weight should be given to the need to moderate interest rate declines until inflation more obviously comes under control, alternative A may be the more attractive alternative.